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SUBJECT: SOUTH AFRICA: MBEKI ECONOMIC ADVISOR OUTLINES THE PATH AHEAD

¶1. (U) Summary. Alan Hirsch, Chief Director for Economic Policy Coordination and Advisory Services in the South African Presidency, met with members of the Southern African Regional Poverty Network on October 7 to discuss South Africa's growth path in the decade ahead. Hirsch said that over the next five years, the Economics and Employment Cluster in the Cabinet would continue policies that supported macroeconomic stability, but introduce new policies to raise the level of private investment in infrastructure to lower the factor cost of production and improve the country's competitiveness. Deep government intervention was required to avoid creating a cycle of dependency on government grants for the nation's poor. End Summary.

¶2. (U) Hirsch opened his presentation by recounting that in January, after the Government published its Ten Year Review, the Cabinet undertook extensive discussions on what was needed to grow and develop the economy. The government had plenty to feel good about. Under ANC leadership, South Africa had achieved macroeconomic stability and the longest period of growth since the 1940s (when GDP was first recorded). South Africa also enjoyed its lowest inflation since 1959 (as measured by CPI) and its lowest interest rates in 23 years. Since the political transition in 1994, GDP growth had stayed positive, averaging 2.8% per year, close to what the major advanced countries were experiencing, but lower than the average for all developed countries (a statistic skewed by the inclusion of a booming China). Hirsch noted that during this ten-year period, the government had managed to raise social expenditures from 44.42% to 56.72% of the budget, and reduce public sector debt to below 50% of the budget. Nonetheless, the Cabinet saw that 3.4 million South African households, about 35-40% of the population, were still living in poverty. Moreover, unemployment had actually grown during the last ten years from 16% to 32% due to new entrants to the labor market (official unemployment is now 29%).

¶3. (SBU) Hirsch said that Cabinet discussions about what to do about reducing high unemployment and poverty continued after the national elections in April. The new Cabinet wanted to know why South Africa was not growing fast enough to improve the welfare of its poor population. According to Hirsch, Foreign Minister Nkosazana Dlamini-Zuma demanded to know why South Africa did not achieve 6% GDP growth by the end of the 1990s, as envisioned under previous economic plans. President Thabo Mbeki replied that the country could have grown faster, but at the expense of marginalizing more of its population. The government's strategic objective now, as enumerated by the African National Congress' election manifesto, was to cut poverty and unemployment in half by ¶2014.

¶4. (U) Hirsch said that the most telling weaknesses of the government's effort from a macroeconomic perspective was its performance on investment, job creation, and economic growth when compared to countries at a similar level of development. He said that private sector investment had declined from 16-17% to 12-13% of GDP over the past ten years and public sector investment had declined from 7-8% to a low of 2% of GDP -- although this increased to 4% of GDP in 2003. He recollected that gross fixed capital formation was 25% of GDP in 1980, the last time the country saw a growth rate of 6%. Since 1992, however, gross fixed capital formation had leveled off to 15-16% of GDP, producing an average growth of around 3%. The question he posed was "Why did public and private investment fall from 1994 onwards?" He attributed this to government's preoccupation with transforming itself from being white dominated to black dominated, with economic restructuring, and to a lack of government confidence. He said that the ANC government feared making too large a commitment on the expenditure side for social services and then not being able to pay for it. Hirsch noted the efficiency of investment improved after 1994 (with capital intensive oriented investment) and economic growth improved somewhat, but it did not lead to greater employment.

¶5. (U) Hirsch believed that the major constraints on investment during the last ten years included the country's relatively high cost of capital, exchange rate volatility, uncontrolled inflation, a low government investment rate, and the country's relatively low growth rate. By 2004, most of

these constraints were no longer important, yet investment as a percentage of GDP continued to be low. Hirsch believed that this phenomenon had to do with misperceptions about South Africa. These included that South Africa faced instability due to income equality among its people and the lack of social cohesion. Another misperception was uncertainty about the government's will and capacity to resolve social problems. Hirsch said that many in business held negative viewpoints about crime, active labor unions, and "whites under siege" in South Africa. The government's apparent protection of Zimbabwe did not help this. Finally, Hirsch thought that some investors had a "gut feel" or "sixth sense" that South Africa was destined to fail. This, he thought, revolved around a lack of trust between the business and ruling classes arising from a cultural gulf between the political and economic elite. For this reason, it was important to establish an organization like the National Economic Development and Labor Council (NEDLAC) and Presidential working groups with industry to be established.

16. (U) Hirsch said that the government's main focus now was to increase the rate of investment. The goal was to reach gross capital formation of over 25% of GDP by 2015. To do this, the government would increase public sector investment to R267 billion over the Medium Term Economic Framework and reinforce its efforts to win over both foreign and domestic investors. He said that monetary stability and successful inflation targeting had led to lower interest rates, and that would help. What remained was to arrive at a competitive and stable foreign exchange rate, which he viewed as currently "mispriced."

17. (U) At the microeconomic level, the government would target priority growth and labor absorbing sectors, such as agriculture, tourism, crafts, telecommunications, mining/metals, clothing/textiles, chemicals, biotech, automobile manufacturing, transportation, as well as services. To support growth in these sectors, government would improve infrastructure in transportation, energy, water, and telecommunications. In this respect, Hirsch admitted that there had been a change of philosophy around state owned enterprises; they would now be employed to lead investment. A concern was that the delivery of many infrastructure-related services were managed by local municipalities, where there was a lack of capacity and something had to be done. Hirsch said that the government would continue undertake what he termed "crosscutting interventions" to promote black economic empowerment, reduce income inequality, and counter investor pessimism.

18. (U) Hirsch went on to discuss South Africa's "second economy," the one that "is peripheral of the cities and towns, and in deep rural areas." He said that one-third of South African households essentially lived outside the system. Poverty and exclusion were leading to rapidly growing demands for public services and transfer payments. If things did not change, social transfers would grow to the point where the government could no longer afford them, and the result could lead to social conflict. Resolving such problems required deep government intervention.

19. (U) Hirsch said that social investment had grown to about 10% of GDP over the past ten years. At the same time, social transfers went from 1.5% to 4% of GDP. Among the major movers in this category were child support grants and disability payments. Government had to do something to break the growing demand and dependency on social grants. Government had to eliminate extreme poverty and at the same time ensure easy mobility to the country's first economy.

110. (U) The government's second economy strategy included creating temporary work opportunities combined with skills and infrastructure development. The government would also focus on home and child services, healthcare and health education, intense skills development, adult basic education and training, and increasing access to capital for small businesspersons. To be successful, he thought that there would have to be more of a two-way flow of information between government and people in the communities affected.

111. (SBU) Comment: Hirsch's overview was heartening in the sense that he grounded the government's economic program in realism. The insight that he provided into government thinking revealed a Cabinet that was growing impatient with high unemployment, low growth, and the government's failure to merge the country's first and second economies. The Cabinet does not believe that the private sector acting alone can deliver what it needs. Privatization will stay on the back burner while the government employs its parastatals to manage and invest in large-scale infrastructure programs designed to foster targeted investment, growth, and employment. Some may question this tack, given that the country's parastatals have consumed more fixed capital than they have created over the past ten years, and are increasingly criticized for ineptitude. Interestingly, Hirsch made no mention of trade policy in his presentation.

